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EU Perspective of the Legal and Economic Aspects of Franchising

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Abstract

The concept of franchising, most often is defined as a method of marketing of goods and services. Certainly this kind of definition is insufficient. Franchising is more than a method of distribution, a specific way of financial depletion of the meaning without an investment of own capital from franchisee. Franchising system of business people give the required experience and access to methods and enable them to get profit from the reputation of the mark which defined reputation. This paper aims to introduce the legal and economic franchising structure with an overview of practice and functionality. It is stated that a regulatory framework comprising harmonized legal systems, is necessary to ensure that businesses can operate across borders efficiently. The EU legal module is main subject of analyzing that include characteristics, economic data, companies' involvement, as well as the comparison of estimate statistics between the EU and USA franchising modules. Additionally, the paper is focusing to the Economic framework of franchising, with strict analysis that the franchising is not achieving its full potential in the EU. The legal consequence of the above mentioned is the risks of franchising as a whole.

At latest stage it is given a real overview of the current observations, recommendations as well as further expectations related to the franchising as a modern form of business in the modern society and busy business environment.

Key words: Franchising system; Economic framework of franchising; legal module.

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1. Introduction

Franchising is a symbiotic relationship between two legally independent businesses that is used in a wide range of sectors and on a broad spectrum of scale and value which can be differentiated from Trade Mark Licensing, Commercial agency and distribution.

Franchising in the European Union, is supposed to be seriously considered as legal framework in which provisions attract franchisors and franchisees to become involved in franchising.

From the regulatory point of view, it is obvious that there is a lack of suitably experienced, authoritative, fully representative and sufficiently resourced franchise associations.

As far as to the product distribution, the Product distribution franchises simply sell the franchisor's products and are supplier-dealer relationships. In product distribution franchising, the franchisor licenses its trademark and logo to the franchisees but typically does not provide them with an entire system for running their business.

Franchising is a wonderful way to go into business for yourself, but not by yourself. Franchising is an example of teamwork at its best, bringing together the talents of a dedicated corporate staff and management team with the hard work, zeal and entrepreneurial spirit of franchisees at the local level to serve our customers and around the world. We hope that you will enjoy reading this book and that you will learn more about this fascinating business and marketing system.

In conclusion of this introduction, it is inevitable that the franchising needs to be legally regulated in the EU. Voluntary regulation will never be able to provide franchisees, potential franchisees or indeed franchisors with the level of protection that they require.

2. Franchise agreement

In most European countries the Franchise Agreement is an unnamed contract of an autonomous commercial law, that it is not regulated with specific rules, but the general principles of the contract law still applies.

As a source of regulations, the general conditions of the franchise companies consists of typical and formed agreements, dispositive norms of civil and commercial law, general commercial practices, as well as judicial and arbitration practice. Because of all this, the Franchise Agreement is very complicated structure.

Special rules for this Agreement can be found internationally in the field of franchise, mainly the two most important acts prepared by legal experts within the UNIDROIT as follows:

- Guide to International Master Franchise Arrangements, since 1998 with revision in 2007, and
- Model Franchise Disclosure Law, since 2002 [3].

In general as a solid and structured legal document, the UNIDROIT Guide [2] offers a comprehensive

examination of the whole life of master franchise arrangements, from the negotiation and drafting of the master franchise agreement and other associated agreements, to the end of the relationship and its effects.

It deals principally with the positions of the parties directly involved, i.e. the franchisor and the sub-franchisor, but, in instances where it is considered to be of particular importance, the positions of others affected, such as sub-franchisees, are covered.

In addition to these two laws, to assist the participants in business relations, the International Chamber of Commerce in Paris in 2000 adopted a Typical International Franchise Agreement as a set of uniform rules that should compensate the lack of National binding-legal dispositive legal norms, which regulate the obligations of International franchise agreements.

The Law and Regulation of Franchising in the EU provides an in depth analysis of the regulatory environment for franchising in the EU. Franchising in the EU comprises nearly 10,000 franchised brands and over €215 billion (US\$300 billion) turnover per annum.

However, compared to its scale in the US and Australia, franchising is not realizing its full potential in the EU and the author points to the lack of homogeneity across members states as a large part of the problem.

This is the step forward in order to emphasizes the impact of EU and member state law upon the use of franchising in the EU [4].

2.1. *European Code of Ethics for Franchising*

The European Code of Ethics for franchising, as a primary source for arranging the rights and obligations of the parties in the Franchise agreements that are concluded on the territory of Europe or whose sides are companies registered in the territory of the countries in Europe, must be emphasized.

The Code states [5] that “Franchising is a system of marketing goods and/or services and/or technology, which is based upon a close and ongoing collaboration between legally and financially separate and independent undertakings, the Franchisor and its individual Franchisees, whereby the Franchisor grants its individual Franchisee the right, and imposes the obligation, to conduct a business in accordance with the Franchisor's concept.

Additionally, the existence of "Know-how" gives more practical overview of the real structure and definition.

By definition “Know-how” means a body of non-patented practical information, resulting from experience and testing by the Franchisor, which is secret, substantial and identified [6].

2.2. *Companies - Franchising system and different forms of enterprises*

It is widely accepted that franchising is an effective development strategy for small and medium-sized businesses both nationally and internationally. It is not surprising that there is growing interest among those who

might be considering involvement in franchising particularly in the countries in transition.

In recent years we have seen fundamental economic and political changes there. Franchising is used most often in services, in areas such as restaurant type fast food, hotel business, retail shops, especially supermarkets, consulting agencies, copy and photocopy services, delivery and transporting services, petrol stations and cleaners.

Few years ago in many countries in transition there were local companies which decided to distribute their products or services using the method of franchising. The good example in this respect is Czech Republic and its first franchising business with McDonald's and Yves Rosher.

Franchising started and made boom in business world in these countries in the third year of the economic transition.

At the end of 2001 there were over fifty franchising systems present in Czech Republic. Foreign franchising brings an influx of foreign capital. Also, the import of a foreign package of services and know-how passed to local entrepreneurs. This is the way of prospect of further continuous development [7].

2.3. Protection

The appropriate level of protection can be measured by reference to four factors:

- The differing degrees of risk involved in different kinds of transaction;
- The differing degrees of experience and expertise that different individuals may have in relation to different kinds of regulated activity;
- The needs that individuals may have for advice and accurate information and
- The general principle that individuals should take responsibility for their decisions [8].

3. The specifics of the current EU regulatory framework

The aim of franchising regulation is very clear and legally structured. In this sense, the Regulation must set, promote, monitor and enforce high standards, in order to contribute to the soundness of the system as a whole and to promote consumers' and institutions' confidence in its strength and integrity [9].

The current franchise specific regulatory framework in the EU comprises franchise laws in eight member states. They focus predominantly upon pre-contractual disclosure and fail to present a homogenous approach to key issues.

This one dimensional approach does not reduce the risks of informational asymmetry and moral risk to which the franchisor is exposed, or the risks of misrepresentation, encroachment, poor quality formats and inadequate

support to which franchisees are exposed. It does not ensure that the economic drivers which attract franchisors and franchisees into franchising are supported. The lack of a homogenous approach between the different EU Member States reduces franchising's cross border potential.

Non franchise specific laws in Member States impact upon the pre-contractual regulatory framework in the EU in several distinct ways:

- They impose a duty not to misrepresent facts;
- An obligation to disclose relevant information to potential franchisees;
- An extra contractual obligation to disclose relevant information to potential franchisees;
- An extra contractual obligation of confidentiality.

An obligation to enter into the Franchise Agreement once negotiations have passed a certain point and the right to withdraw from the contract within a limited time period. Each member state takes a different approach to these issues, resulting in a lack of any homogenous approach.

The ongoing franchisor and franchisee relationship in the EU is impacted by a regulatory framework that comprises a duty of good faith, anti-trust, unfair competition and consumer law. Again there is a complete lack of harmony between the various non franchise specific regimes seeking to regulate the franchise relationship in the EU.

This heterogeneity substantially weakens the ability of businesses to use franchising as a way of entering other EU Member States. It creates a technical barrier over which many franchisors simply cannot climb.

3.1. *Characteristics of EU franchising*

In terms of diversity, it is worth to be stressed that the EU Member state law takes a somewhat different and entirely heterogeneous approach. Eight EU member states have franchise-specific regulatory regimes, but no two are the same. The remaining 19 Member States regulate franchising entirely by the application of general law, again with little homogeneity. Unexpectedly, it is some of the member states without franchise-specific legislation that most heavily regulate franchising. Those member states with Germanic legal traditions treat franchisees as quasi-employees, quasi-consumers and commercial agents. Comparative analysis of empirical data collected by the author makes it possible to determine which of these 27 Member States most rigidly regulate franchising and to benchmark them against the well-established franchising regulatory regimes found in the USA and Australia [10].

Business format of franchising is a specific, distinct and uniform way of exploiting intellectual property rights that has a significant economic impact in the European Union.

It comprises a "basket" of trade marks, copyright material, designs and trade secrets, which together form the blue print for a successful business.

This enables the franchisor to grow its business in an exponential manner. It also allows franchisees to access a proven business format. As a result, franchising stimulates economic activity by offering significant advantages to all those involved, improving market penetration and giving business increased access to other Member States. It comprises nearly of 10,000 franchised brands in the EU, which account for over €215 billion (US\$300 billion) turnover per annum.

A comparative law analysis drawing upon Member States existing laws shows that this underdevelopment of franchising in the EU is, in part, due to the regulatory environment it is subject to. This is primarily because of two distinct factors:

- Firstly, a failure by the EU's regulatory systems to properly govern franchising. It fails both to adequately reinforce the economic drivers that attract franchisors and franchisees to franchising and to reduce to an appropriate level the inherent consequential risk to which both parties are exposed;
- Secondly, there is a lack of homogeneity between the national legal which amounts to a barrier to trade between Member States.

Furthermore, an appropriately drafted directive would not only harmonize the approach of the EU's legal systems towards franchising, but will also re-enforce the relevant economic drivers and reduce the inherent consequential risks to an appropriate level.

3.2. *Effectiveness of the Regulation*

The crucial question raised from the deep research of the franchising is simply related to the effectiveness of the Franchising Regulation in the EU.

In the rush to regulate franchising in EU member states, be it by franchise specific legislation or the application of general law, there has been little thought as regards what the overall purpose of the regulation is, or should be. It often does not go beyond a general feeling that franchisees are unsophisticated "consumers" who are often investing their life savings into complex businesses that may be run by unscrupulous business people with a great deal more experience and little regard for the franchisee's welfare [11].

4. *Economic framework of franchising*

In the European Union during the year 2013 there were approximately about 3700 providers of franchising through 145,000 locations with a turnover of 75 billion euros. From the countries in transition at the top was Hungary with 400 Franchising Chains, of which 50% were domestic. Following were Poland and Slovenia with approximately 120 franchise and Croatia with over 120 providers of franchise, of which 30 were domestic.

In the last few decades the Franchising expanded to more economic areas and now this model of practicing is present in the car industry and the servicing, production and sale of food, catering, hotel management, trading, accounting, advertising and marketing, dental and medical services, insurance, packaging, transport services, laundering, chemical cleaning, pharmaceutical, trade in Real Estate and more.

4.1. Economic data

There is no up to date uniform and complete set of economic data for franchising in all or even the majority of EU member states. This in itself suggests that franchising is not achieving its full potential in the EU.

The most recent figures published by the European Franchise Federation are in respect of 2009, but they only deal with 18 member states and the information given for them is incomplete and in places incorrect. A careful consideration of these figures and a selection of other sources suggest that franchising in the EU currently accounts for approximately US\$300billion.

4.2. An Uneven Spread within the EU

Franchising is not well established in many of the newer and less economically developed EU member states. The figures show that franchising is heavily focused in around a quarter of the EU member states which account for US\$250.4 billion (€180 billion) out of a total estimated turnover of US\$300 billion - the UK, Germany, France, Spain and Italy. In other words less than 25% of the EU member states account for an estimated 83.5% of franchising's turnover in the EU [12].

4.3. Companies' involvement

The economic drivers that lead franchisors and franchisees to become involved in franchising differ. Improved access to both appropriately qualified managerial resource and capital and other economic drivers such as bulk purchasing, economies of scale and enhanced product development explain why businesses use franchising as a way to exploit their intellectual property.

A number of economic incentives resulting in an increased chance of success (such as access to a proven format, a nationally recognized brand, ongoing support, economies of scale and so on), supported by various legal and economic correlatives, explain the attraction of franchising to franchisees.

Franchising is therefore a win-win relationship. Franchisors use it to exponentially grow their businesses, particularly into regions and countries which are otherwise beyond their reach. Franchisees use it to access a "turnkey" business format in order to achieve further development.

Finally, the international franchising industry should focus less on the theory of automatic assignment and place more concern on the dynamics and ripple effects of a master franchise meltdown and deal with the issue of economic value created by the master franchisee by bringing pricing valuations to the negotiation table, ideally on execution date rather than when the local situation and relationship is deteriorating [13].

4.4. Benefits and Risks of franchising

Benefits and risks

The issue of benefits and risks is very crucial element that deserve high level of consideration.

Benefits of franchising for franchisors

Franchises are usually created on the basis of existing successful businesses. The most common reasons behind entrepreneurs' decisions to expand their business using the method of franchise include:

- Market driven need for rapid business expansion;
- High demand for capital to finance rapid business expansion;
- High demand for human resources to ensure rapid business expansion. Employing advantages offered by economy of scale;
- Involvement of motivated and devote people;
- Increase of value of an expanding network;
- Steady cash flows.

Risk of franchising for franchisors

Although franchising seems to be a pretty straightforward business model with little chance of failure for the franchisor, it is full of potential risks that must be evaluated and mitigated. Here we provide just some of those risks that must be kept in mind by a wise franchisor:

- Franchising is a new business;
- The network is as weak as its weakest node; Autocratic decisions may lead to disaster;
- Legal differences in various countries;
- Unfair competition from ex-franchisees.

Benefits of franchising for franchisees

Having discussed the reasons for franchisors to choose franchising as their business expansion method, we can now look at the reasons why acquisition of a franchise is beneficial to franchisees:

- Well-developed technologies, advanced business methods, reliable suppliers and a wide network of partners;
- Advantages of economy of scale;
- Methodical support and advice of the franchisor on how to run the business in a better and more efficient way;
- Well-known franchised trademark which creates pre-conditions for a steady customer flow and reduces the need for marketing activities.

Risks of franchising for franchisee

Franchisors and franchisees must clearly understand the risks inherent in a franchise relationship. Below are several examples of risks that potential franchisees must take into account:

- The inactive franchisor;
- Overinflated expectations of the franchisee;
- The franchisor is too accommodating;
- The franchisor does not listen to his franchisees or vice versa;
- The franchisor is unable to ensure franchisee support [14].

5. Comparison EU vs USA

The USA franchising structure

The USA definition of franchising, for example, includes the following essential elements:

- franchising should be made as contract ;
- there must be a system;
- there must be branding (a trade mark, trade name, etc.) ;
- there must be a grant of rights, and
- must be payment of money.

There are different financial aspects of franchise arrangement.

The cost to the franchisee of joining the business is one of the financial aspects. Sometimes, the element of franchising is a continuing cost. This is the kind of cost, which is paid by membership of the network. It includes the provision of the franchisor's goods and/or services.

The financial aspects of franchising arrangement are very important for all participants in this business. There are the sources of finance, such as banks, finance houses, leasing companies or franchisors. The number of sources of financial assistance has grown.

There are a great number of banks and other financial institutions.

Financial assistance can come from the franchisor, but not so often. Initial fees are the element that is important for all participants in franchising business.

The franchisees have to be able to generate sufficient profitable activity. Because of that, these activities would make the profits, which the franchisees expect.

The nature of the revenue sources depends on the type of franchise. The franchisor would have little prospect of receiving sufficient gross revenue to cover its expenses.

The franchisor would provide a range of services, which will enable the franchisee to prepare him and open for business. Fee, which is provided on this way, covers the cost of the services and training. Continuing fees are one of the possibilities of franchising cost.

These fees sometimes described as a royalty. The continuing fee is paid to the franchisor for more than the use of an asset. It is a payment to the franchisor that enables him to finance activities in providing a wide range of services [15].

The EU has a population of around 500 million compared to the USA's 310.9 million. The EU's Gross Domestic Product in 2012 was US\$16,106,896,000,000 (16.1 trillion) compared to the USA's GDP of US\$14,624,184,000,000 (14.6 trillion).

One might therefore expect the estimated turnover of franchising in the EU and the USA to be similar. However, this is not the case.

The estimated 405,000 franchised outlets in the EU and the estimated turnover of US\$300 billion are dwarfed by the equivalent figures in the US, where in 2010 there were an estimated 901,093 business format franchise outlets employing 9,558,000 and accounting for an output of US\$868.3 billion [16].

Table 1

State	Population on	GDP 2013	Estimated turnover of franchising	Franchising as a percentage of GDP	Turnover of Franchising per head of population
EU	500 million	US\$16.1 trillion	US\$300 billion	1.86%	US\$600
USA	310.9 million	US\$14.6 trillion	US\$868.3 billion	5.95%	US\$5,777

Source: <http://www.fieldfisher.com/publications/2012/05/franchisings-underperformance>

Franchising is not well established in many of the newer and less economically developed EU Member States. The figures show that franchising is heavily focused in around a quarter of the EU Member States which account for US\$250. Approximately 4 billion (€180 billion) out of a total estimated turnover of US\$300 billion, the UK, Germany, France, Spain and Italy.

In other words less than 25% of the EU member states account for an estimated 83.5% of franchising's turnover in the EU. Although the USA has only 60% of the population of the EU and a lower GDP, franchising's estimated turnover in the USA is considerably more than double that in the EU. Compared to the USA, franchising in the EU is markedly underdeveloped.

6. Recommendations

It is clear that none of the EU member states come anywhere close to meeting all of the criteria for good regulation laid out above transparency, proportionality, consistency and accountability. In addition to the lack of a homogenous approach to the regulation of franchising in the EU member states creates a barrier to cross border trade by franchisors.

Obviously, the low quality and heterogeneity of the regulation of franchising in the EU is a clear indication that is highly recommended to the EU Commission that should take a more active interest in franchising and seek to create a legal environment that is more sympathetic to and supportive of it.

Therefore, it is fully recommended that the concept of uniform regulation in a single market really should not be controversial. Uniformity provides efficiency and cost savings. This current situation must be overcome [18].

7. Conclusion

What has been achieved?

The European Commission is unequivocal in its belief that a regulatory framework comprising harmonized legal systems, is necessary to ensure that businesses can operate across borders efficiently.

Despite this clear view of the need for a harmonized approach to the regulation of cross border commerce in the EU, there is a complete lack of homogeneity on the way that franchising is regulated in the EU. This current heterogeneous regulatory environment for Franchising creates obstacles that hinder franchisors from taking full advantage of the single market.

In addition to this, the EU's Regulatory framework also fails to adequately reinforce the economic drivers that attract franchisors and franchisees to franchising and to reduce to an appropriate level the inherent consequential risk to which both parties are exposed. This further hampers the ability of franchising to fully exploit the Common European Market.

The comparative underperformance of franchising in the EU when compared to its performance in the USA is a clear consequence of this lack of homogeneity and the failure of the EU regulatory framework to support the economic drivers which encourage the use of franchising and reduce the consequential risks.

Franchising's disproportionate concentration in the UK, Germany, France, Italy and Spain further exacerbates franchising's failure to promote trade between Member States as much as it could and should do.

The European Union antitrust rules on the distribution of goods are under reform. For years the rules have been criticized both for imposing a straightjacket on business behavior and for outlawing practices that are not obviously anticompetitive.

Many years ago, franchising had its own set of rules in a specific regulation issued by the European Commission, the institution responsible for the implementation of antitrust law in the EU. This was one of a number of regulations applying to different forms of distribution structure: exclusive distribution, exclusive purchasing and so on.

In 1999, the commission issued a new general regulation which provides a "safe harbor" from the application of antitrust law in the EU for all types of "Vertical" agreement provided that the supplier's (franchisor's) market

share did not exceed 30 percent (the Vertical Agreements Block Exemption Regulation).

The application of the safe harbor is also conditional on agreement containing no “hardcore” restrictions of competition. Hardcore restrictions include those which have, at least until recently, been regarded as *per se* infringements in the United States, such as resale price maintenance. They also include controversially many kinds of sales restrictions that are commonly found in exclusive or selective distribution systems and in franchising agreements.

Because of this, it is not possible in the EU to create a system of exclusive franchised territories in which each franchisee is protected from competition from other franchisees of the same brand outside its territory. Finally, it is not possible in the EU to create a system of exclusive franchised territories in which each franchisee is protected from competition from other franchisees of the same brand outside its territory.

What still needs to be improved

The franchising needs to be regulated uniformly in the EU and he suggests that it be accomplished by means of an EU Directive providing for precontractual disclosure for business format franchises rather than a European Civil Code.

His rationale for using a Directive is that a Directive would provide a middle ground by achieving harmonization while allowing EU member states the freedom to choose how to implement the Directive into their national laws [17].

The importance of the development of franchising is that the main intellectual property rights come into play. The concept is developed by means of a pilot operation, which should be, for example: establish business, provide evidence of success to enable the franchisor to sell the "successful" business concept to franchisees

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